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A Natural Experiment in Styles of Capitalism: Professional Sports

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This study compares two professional sports—baseball and basketball. In organization professional baseball comes closer to a US style individualistic capitalism system, with relatively free competition for players and a relatively weak commissioner. Professional basketball, on the other hand, comes much closer to a Japanese style communitarian capitalism system, with limited amounts that clubs can spend on players and with a strong commissioner. While the basketball system protects the economics of small market clubs better, as might be expected, it does not protect their winning records better. Surprisingly, the small market clubs win more in the individualistic system of baseball.

There has been much recent discussion about the decline in US competitiveness. For the past two decades US rates of productivity improvement have slowed dramatically, living standards are barely growing, and trade and budget deficits have been enormous.

Some policy suggestions to correct these problems command wide assent. Most economists believe that if US rates of net national saving were increased, net investment would be increased along with its domestically-financed share, and ultimately living standards would begin rising again. Most economists are also persuaded that the rate of return on research and development expenditures is high enough that these activities should be encouraged, perhaps by the tax system. Some economists believe that added infrastructure investment would also stimulate renewed growth in living standards.[2]

Other policy suggestions to correct these competitiveness problems are much more controversial. Among the most controversial is governmental industrial policy—that somehow the government should guide innovation and perhaps the allocation of investment funds to private industry. Various authors have argued back and forth on this issue, differing essentially on the issue of how much faith can be placed in government to be a beneficent force in product and credit markets in the long run.[3]

Lester Thurow (1992) characterizes this debate as one between those believing in US style individualistic capitalism and those believing in Japanese style communitarian capitalism.[4] Individualistic capitalism is plain old textbook free enterprise capitalism, featuring individual values, competition between firms in an industry, and little or no government intervention. Communitarian capitalism is still capitalism, but with much more focus on community values and cooperation and much less on individual competition. Rather than competing, companies can be interlocked financially, work together, and even have collective strategies. Rather than just enforcing anti-trust statutes, government can work with business to promote the industry, allocate resources, and even take steps to help weaker firms survive in a competitive world. There might also be a referee to manage industrial systems and prevent behavior that might harm some firms. This referee might be the government's industrial policy division, or perhaps simply created by firms in the industry to keep the industry running smoothly. Communitarian capitalism is generally not practiced in the United States, and indeed most versions of communitarian capitalism would be illegal under US anti-trust statutes.

When posed as a comparison between the Japanese and American systems, the Japanese model might seem superficially attractive. Over the 1971–85 period, US real GDP grew by 2.7 percent per year while Japanese real GDP grew by 4.3 percent per year, despite the fact that the US labor force grew slightly more rapidly. The difference may not seem like much, but over a fifteen year period leads to a gap in per capita living standards of about one-third. Of course there could be many explanations for the growth rate disparity that have nothing to do with industrial policy or the style of capitalism. The Japanese save a much higher share of their output, they work and go to school longer hours, and their students do better on standardized tests. But the suspicion persists—perhaps US style individualistic capitalism is not the wave of the future.

In theory the ideal way to evaluate styles of capitalism would be to do an experiment. The US has been under an individualistic capitalism system for a long time now. Perhaps the US or sectors of US industry could convert to communitarian capitalism, with the outcomes to be compared. In practice, of course, there are many problems. Institutions of capitalism cannot just be changed overnight or in particular sectors, other factors will always affect growth rates, and it will always be hard to pin down causes, effects, and statistical correlations.

But there is at least one natural experiment that may shed some light. Because of various anomalies in laws regarding the organization of professional sports, the US has actually run different capitalism systems over the 1980s. Professional football and hockey have yet to emerge from the old reserve clause system where the clubs own the contracts of their players, but the other two major professional sports, baseball and basketball, have had essential free agency for more than a decade now. In baseball the free agency system comes close to US style individualistic capitalism. In basketball the free agency system comes much closer to Japanese style communitarian capitalism. This study compares these two systems to see how they have worked over the 1980s.

THE ORGANIZATION OF PROFESSIONAL SPORTS

At the outset it should be admitted that professional sports are far from competitive industries where firms can enter and leave the industry at will. All professional sports are cartels, where the entry and exit of new clubs is rigidly controlled. The clubs are divided into leagues, with each league having a certain number of clubs, and with definite rules about who plays whom, in what city, how pennants and world championships are determined, and how gate receipts and television revenues are split up. To organize all this, all professional sports are given control over the number of their franchises, their revenue-sharing conventions, and rules for bringing new players and clubs into the leagues. Baseball has more control than the other professional sports because of its special anti-trust exemption, which gives it added control over the location of its franchises.[5]

From a competitive point of view, league competition would be best balanced if each major league team played in a city with constant revenue potential. For gate receipts alone, this equal-revenue ideal is difficult to achieve because of inherent disparities in US city sizes—teams from the New York area with nearly 20 million people compete against teams from Kansas City, Cincinnati, Milwaukee, and Phoenix, all with metropolitan area populations of about 2 million people. City sizes vary widely in the United States, and there is not much that professional sports can do about that.

It is, of course, possible to equalize revenue potential. Professional football comes the closest to this ideal because most football revenue comes from its national television contract that pays each club the same amount. The indoor sports, basketball and hockey, come reasonably close because indoor arenas can only be so large, limiting at least this component of the variance in club revenues. Professional baseball achieves the least amount of equalization because the national television contract provides only a small share of the revenue, outdoor stadiums can hold large numbers of people, and there are 162 games played in these outdoor stadiums.

How would city size disparities affect competitive balance? Since the revenue potential is larger in larger cities, the price of large market franchises should be bid above the price of small market franchises. Since good players can add to revenues more in large markets, these players would be worth more there and talent would flow to the large markets.

The capital market equilibrium is then that owners have a choice—buy a large market club for more, but have a greater chance of getting good talent and winning championships; or buy a small market club for less and with less chance of winning. This may seem unfair to a small market owner, but if a small market owner wants to win more, all he has to do is to sell his franchise, get some new capital, and buy a large market franchise. Or, if the league permits and there happens to be a larger market without a club, he can move his club.

This market-based competitive imbalance may seem unfair to fans in small market cities, but it is at least efficient. On average there would be more pennant races in large markets, benefitting more fans and bringing in more total revenue to the clubs. If a particular fan wanted to enjoy more pennant races, she would either have to move to a larger market or get a satellite dish. So from both an efficiency and an equity standpoint, there is some logic to the market-based competitive imbalance in a league where teams have different revenue-potentials.

As for player compensation, switching from a regime of the reserve clause to free agency in such a system should alter the distribution of income but not competitive balance. Should leagues still operate under the old reserve clause system where the clubs own the player contracts and can trade or sell players virtually at will, the clubs get all the surplus created by the players. When and if the reserve clause is broken, as it was more than a decade ago for baseball and basketball and as is now in process in football, average player salaries would be expected to rise and average club profits to fall. But as was pointed out by Simon Rottenberg (1956) nearly four decades ago, this dramatic shift in rewards should have little effect on competitive balance. Whether players are paid as free agents or under the reserve clause system, good players would be worth more in large cities than in small market cities and they would tend to gravitate towards large market cities. The clubs in those cities would have to pay for these players, and the only question is whether the large market clubs pay the players themselves, as under free agency, or the clubs that previously owned the players' contracts, as under the reserve clause system.[6]

What does all this have to do with styles of capitalism? Baseball has adopted a weak commissioner system (so weak in fact that the sport has operated for more than a year now without any commissioner). Within this system clubs are on their own to compete as they wish, trying to earn more revenue or trying to win more pennants. Individualistic values are encouraged, the clubs compete against each other for revenues, and with the players to divide up the revenues. Call the baseball system individualistic capitalism.

Basketball has, on the other hand, adopted a strong commissioner system. Under the basketball system all clubs are prevented from bidding as much as they would like for players—indeed, all clubs are under a constant amount player salary cap expressly designed to eliminate market size effects (to be explained further below). This salary cap yields extra profits for those clubs, typically from large markets, who would have otherwise used their higher revenue potential to raise their payroll and bid star players away from small market clubs. The cap also protects the profits of the small market clubs, and should help the competitive balance of small market clubs because all are competing for players on even terms. According to Rottenberg's principle, a movement to free agency should not alter the talent flow to large market clubs or competitive balance, but the basketball constant player salary budget system should because that in effect eliminates the whole concept of large and small market clubs. In the basketball system clubs find it much more difficult to compete against each other for players, the players and the clubs work together to maximize revenues subject to a pre-agreed split of these revenues, and the system is administered by a powerful referee. The basketball system comes much closer to what Thurow might call communitarian capitalism.

Individualistic Capitalism—Professional Baseball

Since the dawn of free agency in baseball in 1978, player salaries have escalated rapidly, by 11 percent per year in real terms over a fourteen year period. But after the strike of 1981, total club revenues have not done badly either, growing at 9 percent a year in real terms from 1981–1991, with rapid growth both in gate and television receipts. Average player salaries rose from 30 to 48 percent of club revenues between 1978 and 1981, but since 1981 the ratio has leveled off at about 50 percent. The public moaning about player salaries one hears in the press seems to be one part pure sticker shock, one part ignorance of the rapid growth of revenues, and one part a valid fear of what will happen if revenues do not keep on growing. Revenues may well not keep on growing given the fact that the national television networks are now losing money on their latest baseball television agreement.

As Rottenberg would have predicted, this transition from a reserve clause system to free agency has been accomplished with minimal disruption to competitive balance. In fact, competitive balance in major league baseball has never been better—the variance in performance between winning and losing clubs is now the lowest it has been in the postwar period, as is the performance differential between large and small market clubs. Small market clubs such as the Pittsburgh Pirates, the Minnesota Twins, the Oakland A's, and the Cincinnati Reds win often these days, much more than their predecessor small market clubs did under the reserve clause. For example, in the thirteen year period between 1980 and 1992, small market clubs won the World Series 7 times and another 7 small market clubs finished second (that is, got into the World Series but lost). Baseball's economic study commission found that on average quadrupling the market size of a typical small market club to make it into a large market club would increase its number of wins by only two or three a year, a tiny amount given the fact that the average distance between first and second place in a division over this period was six games.[7]

On the economics side, the story is possibly different. The owners, looking at club income statements, argue that 11 of the 26 clubs are *financially troubled* now, with perhaps more joining the list if television revenues turn down. Using an accounting concept that assumes all clubs are equity-financed and hence ignores interest costs, most of these clubs do have negative profits, and most are in small markets. But even though many clubs lose money in this sense, there have been sufficient real capital gains in baseball that even these negative-profit clubs have averaged at least normal internal rates of return.[8] There could be many reasons for the disparity between income statement profits and asset values—potential owners could simply want to get into baseball at any price or there could be nonmonetary reasons for owning clubs. But while the large market clubs have driven salaries to a level where it is difficult for small market clubs to make money, there still does seem to be enough asset demand for small market franchises to make at least normal rates of return.

As a remedy for the negative profits, the owners have proposed that baseball go over to a player salary cap system similar to that of professional basketball. The players' union has resisted, arguing that the impending financial doom is at a minimum overstated. Apart from any comparisons between styles of capitalism, there is a nice irony here. The owners, hard-nosed capitalists and probably conservative Republicans for the most part, are arguing for a switch away from individualistic free enterprise capitalism to a more communitarian system. The players' union, normally quite loyal to union traditions, is arguing for maintenance of the individualistic capitalism free enterprise status quo.

Communitarian Capitalism—Professional Basketball

Fifteen years ago professional basketball was a mess. Many franchises were broke, franchises were switching location often, television revenues were low, the league had a major drug problem, and there were serious doubts that a league populated almost entirely by black athletes could ever be successful in predominantly white America. At the time the league worked out a salary cap system that imposed a flat salary ceiling, the same for all clubs regardless of market size or revenue potential. The sum of players salaries across all clubs was set at 53 percent of the sum of club revenues, about the same aggregate ratio as in baseball, but unlike baseball, each club could only pay their constant share (1/27th) of this amount, the same amount for all clubs. Profits of the large market clubs have benefitted directly from the player salary cap, and profits of the small market clubs have benefitted indirectly from the reduced salary bidding by the large market clubs. The players had a constant fraction of the revenue growth in basketball without the periodic haggling over profits that would have otherwise taken place in an individualistic capitalism system.

Whether because of salary cap or the exogenous rise in the popularity of professional basketball, the economics of professional basketball look totally different today. There have been no franchise relocations for a decade now, many small market franchises are now thriving, new franchises have entered the league and are doing well economically, revenues are rising rapidly, and the television networks seem to be doing well by their basketball contract.[9] From a financial point of view, the future looks much brighter for professional basketball than for professional baseball, and indeed basketball franchises now sell for about the same price as baseball franchises of the same market size even though total basketball revenues are only about half as large as in baseball. It is logical to ask if the salary cap agreement is not at least partially responsible for the newfound financial health of professional basketball.

This salary cap agreement seems to operate much as a communitarian capitalism system might. There is an incentive for players and the clubs to work together to maximize total revenues, which are to be split up according to agreed-on ratios. The clubs cannot make lucrative offers to players once they have hit their salary cap. The cooperative system is administered by the basketball commissioner, David Stern, who seems to be very popular with clubs and players alike. Stern has also been a leader in joint marketing of the whole sport—merchandising, exporting basketball to foreign countries, community relations, and the like. While his counterpart in major league baseball, Fay Vincent, was resigning under pressure in the summer of 1992, Stern's assistant, Gary Bettman, was being hired as hockey commissioner to import some of basketball's magic.

From this point of view, all looks fine for the communitarian capitalism system of professional basketball. But there is another dimension too. Professional sports clubs compete on two dimensions—they try to earn profits and they try to win championships. The player cap scheme of professional basketball seems to have protected the small market clubs' profits, as it was designed to do. But in attempting to eliminate or weaken the impact of market size, it was also designed to protect the winning records of small market clubs. Has it done that? Have the small market clubs done as well as in baseball, where they have won more than half the championships since 1980.

Surprisingly, no. In professional baseball small market teams have won 7 times and finished second 7 times since 1980. In professional basketball over the same period small market teams have won no championships and only qualified for the finals twice (the Portland Trail Blazers in 1990 and 1992). I have not done all the careful econometrics done by baseball's economic study commission, but it is obvious that the market size effect on winning games would be much larger than for baseball.

There could be all sorts of reasons for the disparities in winning, and I only throw this out as a suggestive finding. On one side, the presence of the college draft in professional basketball only adds to the puzzle. College players are drafted at a stage in their career when professional success can be much better predicted than in baseball, and the draft gives a real advantage to the losing teams, which generally have been the small market teams. Yet still the winning disparity persists. On the other side, it is possible that eventually the presence of the salary cap and the player draft will spread the talent to the small market clubs, and eventually they will start winning more games and championships.

But there may also be deeper and more meaningful reasons for the surprising finding. Player salaries can be capped, but large city endorsements cannot be, suggesting that it may be quite difficult to design a centralized system that protects the winning records of small market clubs. It is also possible that there are ways in which a system that seems designed to help the small market clubs stay in business may be altered subtly to have quite different effects. As one example, when the Boston Celtics, a large market club, could not afford to re-sign their star player, Larry Bird, without violating their salary cap, the commissioner introduced a *Larry Bird rule* that permitted the Celtics to violate their salary cap to re-sign Bird. It is possible that in keeping the large market clubs happy with the overall system, the commissioner is making some subtle deals with the large market clubs that give them a competitive edge.

A TENTATIVE EVALUATION, INDIVIDUALISTIC VS. COMMUNITARIAN CAPITALISM

The intrinsic advantages of the individualistic capitalism system are those by now standard for free enterprise. Clubs are free to compete for profits, winning, or some combination exactly as they wish. Can star players such as Ryne Sandberg and Barry Bonds possibly be worth $7 million a year? Leave it to the market to decide. If there are owners willing to pay these amounts, then the players are worth that.

Of course, free enterprise capitalism has its excesses, and there is always the chance that these will crop up in baseball. One possible excess is that in the free enterprise system large market clubs can bid away all the star players, win all the time, and make many baseball games not much fun to watch. As far as anybody can tell, this does not seem to be happening. Despite the large variance in revenues, somehow or other small market clubs manage to keep on winning just about as often as large market clubs, pennant races are tight, and the fans are either coming out or tuning in to their cable network, as witnessed by the rapid decade long growth in total revenues. Another possible excess is that it would be such a struggle for the small market clubs to compete financially with the giants that the small market clubs would lose money and sell for poor prices. Make negative profits? Possibly yes, as the owners claim. Sell for poor prices? No. Even with all the perceived troubles of major league baseball, there is still a bidding war for franchises in small as well as large markets, and even small market baseball franchises have been reasonable investments over the past decade. Another possible excess is that the haggling over money, and the large player salaries, will antagonize fans and cut down on baseball's revenue growth. But revenues have risen very rapidly, at 9 percent a year in real terms, over this period when baseball has supposedly been in trouble. There are possible excesses from individualistic capitalism, but at least to this point precious little evidence of these excesses has cropped up in professional baseball.

The intrinsic advantage of communitarian capitalism is that instead of competing, the clubs work together to try to maximize industry profits. In baseball players and owners squabble over the distribution of the revenue pie; in basketball both players and owners gain if the pie grows, so there is an incentive for players and owners to work together to make the pie grow. Even though competitive balance has not suffered, the squabbling has reached a high level in baseball—the last seven times the basic baseball agreement has been renegotiated, there have been exactly seven work stoppages. Labor relations are much more harmonious in professional basketball. In this sense communitarian capitalism seems to be alive and well in professional basketball.

Indeed, there seems only one fly in the ointment for professional basketball—why do not the small market clubs win more? Is this happenstance, the fact that the really dominant players such as Magic Johnson, Larry Bird, Kareem Abdul Jabbar, Julius Erving, and Michael Jordan have all landed in large markets, or is it more deeply indicative? Does it suggest that even in a system that seems set up to protect the weak, it is either quite difficult to do that or the referee has to keep giving the edge to the large market clubs to keep them from breaking the cooperative system?

In more abstract terms, there seem to be two basic issues involved in the choice between individualistic and communitarian capitalism. The first is whether the government, or administrator of the communitarian capitalism system, adds value. Does the market work better with or without central intervention to administer the salary cap in a fair and impartial way, protect the small market clubs, and limit competitive excesses? Those who fear industrial policy fear that some political person or agency will not be able to carry out these functions effectively and/or impartially. And, even if the basketball commissioner adds value, it should be remembered that this commissioner was selected by and is accountable to the clubs. For a real industrial policy in a political setting it may not be possible to get nearly as competent a referee, adding to the costs of the communitarian system.

The second basic issue is which underlying characteristic of an industrial system should be promoted—competition or cooperation. The baseball system promotes competition, as witnessed by the fact that the small market clubs win so often, and seems to be abysmal on cooperation, as witnessed by its difficult labor history. The basketball system seems just the reverse—all clubs have cooperated with the system for more than a decade now, but for some reason the small market clubs do not win championships. Both goals may be important, but for public policy purposes that claim is not nearly enough. Competition either has to be individualistic or not, industrial policy and/or referees must be installed or not. How to devise a structure that promotes the optimal blend of both values is still the deep, dark question.

Until such a way is found, and perhaps after that, it frankly remains a mystery which system might work better. Those who are concerned more with individualistic values probably appreciate more the even-handed baseball outcomes; those who are concerned more with community values probably appreciate more the harmony of basketball. If there is a deeper lesson here, it is that these issues are quite complicated, and that the US government should proceed quite carefully before tampering with its own competitive system.

NOTES

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1. Much of my specific knowledge on this topic comes from serving as the staff director to Major League Baseball's Economic Study Commission in 1992. The Commissions results are used in the paper, but all opinions expressed are my own. Also, Sheldon Danziger, Robert Haveman, Helene McCarren, and Richard Porter made helpful comments on an earlier draft.

2. For some discussion of national saving and research and development, see Charles Schultze (1992). The infrastructure question is discussed in Alicia Munnell (1990).

3. These issues are discussed in a symposium on industrial policy sponsored by the Kansas City Federal Reserve Bank (1983).

4. Thurow attributes the term to George Lodge (1991).

5. There is a raging debate about the importance of the anti-trust exemption. See Gerald Scully (1989) and Andrew Zimbalist (1992) for contrasting positions. Roger Noll asserts that the anti-trust exemption gives baseball owners the power to break the players' union with a lockout that cannot be challenged in court. But it is not altogether clear that the anti-trust exemption would survive such a brazen attempt to use it forcefully.

6. Rottenberg's proposition, known as the invariance principle, is discussed by George Daly (1992).

7. See Gramlich, Hays, Brown, Solon, and Miller (1992).

8. Gramlich et al. (1992).

9. Professional basketball expanded to Denver and Miami before baseball, and there are now thriving basketball franchises in Orlando, Charlotte, Indianapolis, San Antonio, Salt Lake City, Phoenix, Portland, and Sacramento—all of which are probably too small to support professional baseball franchises.

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